In the Supreme Court of the United States

OCTOBER TERM, 1970

No. 644

LANSING BROADCASTING COMPANY, A MICHIGAN CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (Pet. App. 11–21) is reported at 52 T.C. 299. The opinion of the court of appeals (Pet. App. 22–26) is not yet reported.

JURISDICTION

The court of appeals entered an opinion and judgment on June 5, 1970. A petition for rehearing was denied on July 16, 1970. The petition for a writ of certiorari was filed on September 3, 1970. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

404-947—70

QUESTION PRESENTED

Whether the phrase "sales or exchanges of stock" in Section 1372(e)(5) of the Internal Revenue Code of 1954 includes liquidation distributions received by petitioner with respect to its stock in another corporation.

STATUTES INVOLVED

Internal Revenue Code of 1954 (26 C.F.R.):

> SEC. 331. GAIN OR LOSS TO SHAREHOLDERS IN CORPORATE LIQUIDATIONS.
>
> (a) *General Rule.*—
>
> (1) *Complete liquidations.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock.
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> * * *
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> (b) *Nonapplication of Section 301.*—Section 301 (relating to effects on shareholder of distributions of property) shall not apply to any distribution of property in partial or complete liquidation.
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> * * *
>
> SEC. 1372 [as added by Sec. 64(a), Technical Stat. 1606]. ELECTION BY SMALL BUSINESS CORPORATION.
>
> * * *
>
> (e) *Termination.*—
>
> * * *

(5) *Personal holding company income.*—An election under subsection (a) made by a small business corporation shall terminate if, for any taxable year of the corporation for which the election is in effect, such corporation has gross receipts more than 20 percent of which is derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of this paragraph only to the extent of gains therefrom). Such termination shall be effective for the taxable year of the corporation in which it has gross receipts of such amount, and for all succeeding taxable years of the corporation.

* * * *

STATEMENT

Petitioner is a Michigan broadcasting corporation which, since 1948, has operated in Lansing, Michigan, under the call letters "WILS." On December 1, 1958, petitioner elected under Section 1372(a) of the Internal Revenue Code to be taxed as a partnership and met all the requirements of that statute. From January 1, 1958, through December 31, 1964, the election was not terminated by any corporate revocation or through the addition of any new shareholders who failed to consent to such election. (Pet. App. 23.)

In 1962, petitioner owned 21,450 shares of common stock of Chief Pontiac Broadcasting Company (Chief Pontiac), 53.625 percent of the issued and outstanding stock of that corporation. Pursuant to a plan of complete liquidation under Section 337 of the Code,

Chief Pontiac, on October 15, 1962, sold substantially all of its assets for cash. Thereafter, in 1962 and 1963, it made distributions to its shareholders in complete liquidation. (Pet. App. 23.)

On the date of the final distribution, May 28, 1963, petitioner surrendered its stock certificate to Chief Pontiac for cancellation (Pet. App. 23). On its 1962 federal income tax return, petitioner reported its income as follows (Pet. App. 24):

Gross receipts	$569,048.19
Interest on U.S. obligations	5,552.59
Rent	1,689.10
Net long term capital gain	166,237.50
Other income	8,971.04
	$751,498.42

Petitioner's net long-term capital gain of $166,237.50 resulted from the 1962 liquidation distribution it received from Chief Pontiac after subtraction of its cost basis of $21,450 (Pet. App. 24).

Section 1372(e)(5) of the Internal Revenue Code provided that a corporation's election under Subchapter S of the Code shall terminate if in any year the corporation received more than 20 percent of its gross receipts from "Personal holding company income," which included receipts from "sales or exchanges of stock" and "dividends." Twenty percent of petitioner's gross receipts in 1962 totaled $150,299.68. The Commissioner determined that the liquidating distribution petitioner received from Chief Pontiac in 1962 ($166,237.50), together with its income from rent

and interest on U.S. obligations ($7,241.69), constituted "personal holding company income" totaling more than 20 percent of its gross receipts for that year, and that, accordingly, its election under Subchapter S terminated as of January 1, 1962. (R. 14a–15a.)[1]

The Tax Court upheld the Commissioner's determination, reasoning that the liquidating distributions to petitioner in return for petitioner's Chief Pontiac stock constituted receipts derived from "sales or exchanges of stock" within the meaning of Section 1372 (e)(5) (Pet. App. 14–21). The court of appeals affirmed, holding that the liquidating distributions constituted exchanges for stock, or in the alternative, dividends, either of which would require automatic termination of petitioner's Subchapter S status under Section 1372(e)(5).

ARGUMENT

The decision below is correct. There is no conflict or any other basis for further review by this Court. Indeed, as petitioner concedes (Pet. 6, 7), this is a case of first impression.

1. Subchapter S of the Internal Revenue Code of 1954 (Sections 1371–1378) allows a closely held corporation to forego the payment of any corporate income tax and requires its shareholders to report the corporate income (whether or not distributed) as their own for tax purposes. Congress' intent was to allow businesses to select a legal form without regard to tax consequences, to assist small business corpora-

[1] "R." references are to the record appendix filed in the court of appeals.

tions where the shareholders were in a lower tax bracket than the corporation, and to allow corporate losses to be offset against the shareholders' individual income from other sources. S. Rep. No. 1983, 85th Cong., 2d Sess., pp. 87–88. Congress qualified these benefits, however, by providing in Section 1372(e)(5), *supra*, pp. 2–3, that Subchapter S treatment shall terminate if the corporation received in any taxable year more than 20 percent of its gross receipts from "Personal holding company income,"[2] defined as "gross receipts * * * from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities * * *."

The legislative history of Section 1372 reflects the Congressional intent to limit the availability of Subchapter S to companies "actively engaged in trades or businesses" and to disqualify corporations which received a substantial amount (more than 20 percent) of their gross receipts from investment or passive income sources. S. Rep. No. 1007, 89th Cong., 2d Sess., p. 8; H. Rep. No. 1238, 89th Cong., 2d Sess., p. 8. The committee report accompanying the original legis-

[2] The term "personal holding company income" was changed to "passive investment income" in 1966, apparently to distinguish it from "personal holding company income" as that term is used in Section 543, Act of April 14, 1966, P.L. 89–389, 80 Stat. 111, Sec. 3(a). The committee reports accompanying the 1966 legislation indicate that the amendment was only a matter of phraseology and not a change of substance, stating that the new term "contain[s] the same general rule as existing law" and that "passive investment income" means "the same gross receipts as are taken into account under existing law." S. Rep. No. 1007, 89th Cong., 2d Sess., p. 20.

lation states that interest, dividends, rents, royalties, "*or other forms of passive income*" must be limited. (Emphasis added.) S. Rep. No. 1983, *supra*, p. 89. That petitioner's gains from the liquidation of Chief Pontiac come within the passive investment type limitation is fully supported by the Tax Court's uncontested finding (Pet. App. 18–19) that petitioner held its Chief Pontiac stock as an investment rather than as part of its business operations.

2. Petitioner's contention that the courts below erred in looking to Code Section 331(a)(1), *supra*, p. 2, to determine that the liquidation distributions in issue should be "treated as * * * in exchange for the stock" is without merit. First, Sections 1.1372–1(c)(1) and 1.1373–1(c) of the Treasury Regulations on Income Tax (1954 Code) provide that a Subchapter S corporation must apply the provisions of Chapter 1 of the Code (which includes Section 331) in computing its income. Section 331(a) is the correct—indeed the only—statute which sets forth how a liquidating distribution is to be treated in computing a shareholder-corporation's taxable income. This computation must be performed and an annual return submitted even though there is no tax on the Subchapter S corporation's income. See Section 6037; see also Sections 1373–1378. While petitioner condemns this "reaching outside" of Section 1372 to characterize the liquidating distribution, it does not challenge the validity of the Treasury Regulations, nor does it suggest an alternative method or authority

for determining the nature of the liquidating distributions to it.[3]

Second, petitioner itself reported (R. 6a, 14a) the gains from the liquidating distributions as capital gains, obviously relying on Section 331(b), since Sections 301(a) and 316 would otherwise require that such amounts be treated as dividends. It would be illogical to allow petitioner on one hand to rely on Section 331(b) to report the gains from the liquidating distributions as capital gains, and on the other to ignore the denomination in Section 331(a) of such distributions as payments "in exchange for the stock."

Third, the legislative history of Section 331 reveals that the "ordinary meaning" of a liquidating distribution is that of a "sale by the stockholder of his stock to the corporation" in return for money. S. Rep. No. 398, 68th Cong., 1st Sess., pp. 11–12.[4] Petitioner's con-

[3] The fact that Section 1.543–1(b)(5) of the Regulations, interpreting the phrase "Gains from the sale or exchange of stock" in 1954 Code Section 543(b)(2), states that this phrase "include[s] gains from liquidating dividends" is not relevant here. This inclusion was placed in Article 351–2 of Treasury Regulations 94 for clarification when the predecessor of Section 543, Section 351(b) of the Revenue Act of 1936, c. 690, 49 Stat. 1648, read only "gains from the sale of stock." The reference to "liquidating distributions" in the Regulations was retained after the words "or exchanges were added to the statute by Section 1 of the Revenue Act of 1937, c. 815, 50 Stat. 813. See generally 7 Mertens, *Law of Federal Income Taxation* (Rev. ed.), Sec. 40.07. Section 543(b)(2) was repealed for taxable years after December 31, 1963, by Section 225 of the Revenue Act of 1964, P.L. 88–272, 78 Stat. 19.

[4] Contrary to petitoner's argument (Pet. 7), there is no danger that application of the words "treated as a sale or exchange" or the like in other revenue statutes, in conjunction with Section 1372(e)(5), will lead to distortion of the latter

trary claim (Pet. 7–8) is without supporting authority and contradicts the Congressional conclusion that liquidating distributions constitute exchanges of stock for corporate assets.

3. As the court of appeals alternatively held (Pet. App. 26), if the liquidating distributions were not treated as exchanges for stock under Section 331, then they would have to be dividends under Sections 301(a) and 316. This rationale, to which petitioner has not addressed itself in this Court, would also require termination under Section 1372(e)(5) of petitioner's Subchapter S election for the taxable years in issue.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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statute. Turning to petitioner's examples, treatment of timber cutting as a sale or exchange pursuant to Section 631(a) is by election only; it is thus easily avoided by a Subchapter S corporation. Section 1244 applies only to individuals, not corporations. See Section 1.1244(a)-1(b) of the Treasury Regulations. Section 1235 describes the tax treatment of the transfer of all substantial rights to a patent. Such transactions involve essentially investment type income, the substantial receipt of which Section 1372(e)(5) was designed to prevent.

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